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FREE AT LAST? THE CONTRACTUAL THEORY OF THE CORPORATION AND THE NEW MARYLAND OFFICER-DIRECTOR LIABILITY PROVISIONS

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I. INTRODUCTION

Perhaps the most significant debate in corporation law today concerns the extent to which corporations and their shareholders should be free to order internal corporate relations, in particular the fiduciary duties of officers and directors. One view is that the corporation is a set of private contractual relationships and, as such, should be no less amenable to private ordering than other contracts.¹ The competing view holds that the corporation differs fundamentally from a conventional contract and, as such, should be subject to mandatory rules.² This latter, or anti-contractualist, position derives in part from the now outmoded original view of the corporation as a creation or concession of the state.³

The debate on the nature of the corporation has been brought to a head by a number of recent developments, particularly the explosion in takeover activity⁴ and the so-called "crisis" in director liability insurance.⁵ The latter development has spurred state legislatures to enact one or both of two different types of corporation law provisions.⁶ The first

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1. See, e.g., R. HESSEN, IN DEFENSE OF THE CORPORATION (1979); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Butler & Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, (forthcoming WASH. L. REV. (1990)).

2. For statements of the anti-contractarian position, see Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Coffee, *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919 (1988).

3. For an attack on the continued relevance of the concession theory of the corporation to modern corporation law, see Butler & Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611 (1988) [hereinafter Butler & Ribstein, *Anti-Takeover Statutes*].

4. *Id.* at 647-55 (relating the contract theory of the corporation to state anti-takeover statutes).

5. There is a widespread impression that such a crisis exists without addressing the serious question of whether there is a real crisis in director liability insurance. For an analysis of the problems in the director liability insurance market, see ROMANO, WHAT WENT WRONG WITH DIRECTORS' AND OFFICERS' LIABILITY INSURANCE? (Working Paper No.71, Yale Law School, Program in Civil Liability, Jan. 1988).

6. For discussions of these statutes, see Hazen, *Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C.L. REV. 171 (1987); Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 TEMPLE L. Q. 13 (1988).

type of provision explicitly authorizes corporations to adopt by shareholder vote charter provisions limiting director liability.⁷ The second type of provision changes the liability rules by legislative fiat without action by the shareholders.⁸ Maryland has recently added both types of provisions.⁹

The director liability crisis and the statutes that have been enacted to resolve it present a perfect opportunity to demonstrate both the strengths of a coherent contractual theory of the corporation and the operation of such a theory in practice. The liability crisis, if there is one, may have occurred because the parties to corporations have not been given free rein in drafting their managerial contracts. Offering more contractual freedom to shareholders, therefore, will go a long way toward solving the director liability problem. But state legislatures should learn a lesson from this crisis and fully accept the implications of the contractual theory. Because the new Maryland provisions, like similar provisions in other states, do not fully accept the implications of the contractual theory, they raise significant practical and theoretical problems.

This article examines the recent Maryland statutory changes from the perspective of the contractual theory of the corporation. In general, it discusses how the two types of provisions adopted in Maryland raise different types of concerns under the contractual theory of the corporation. Part II briefly outlines the contractual theory of the corporation and its implications for contracting in and out of fiduciary duties. Part III discusses the new Maryland shareholder option provision and demonstrates that this type of provision is consistent with the contract theory except to the extent that it limits the shareholders' options. Part IV examines the new Maryland indemnification provision which raises serious concerns both under the contract theory and the Contract Clause of the United States Constitution because it amounts to a retroactive change in the shareholders' contract. Finally, Part V offers concluding observations.

II. THE CONTRACTUAL THEORY OF THE CORPORATION

The contractual theory of the corporation is a positive economic approach to corporate law that is strongly supported by current economic theory. The contractual theory describes the corporation as a nexus of

7. See, e.g., MD. CORPS. & ASS'NS CODE ANN. §§ 2-104(b)(8), 2-405.2 (1985 & Supp. 1988).

8. This category includes both expansion of indemnification power as in § 2-418 of the Corporations and Associations article of the Maryland Annotated Code and limits on officer and director liability as in the new Virginia statute. See MD. CORPS. & ASS'NS CODE ANN. § 2-418 (Supp. 1988); 1987 Va. Acts ch. 257 (amending VA. CODE ANN. § 13.1-692.1(B) (1989)). For a discussion of the latter provision, see Honabach, *All That Glitters: A Critique of the Revised Virginia Stock Corporation Act*, 12 J. CORP. L. 433, 472-79 (1987).

9. See *supra* notes 7-8.

voluntary contracts rather than a set of mandatory legal rules. Under the contractual theory of the corporation, corporation decisional rules and statutory laws are merely standard form contracts. The normative implication is that the parties should be able to contract around statutory law.

Much of the theoretical work supporting the contractual view of the corporation refutes a seminal 1932 work by Berle and Means.¹⁰ Berle and Means argued that managers of large, dispersed-owner corporations have effective control over their corporations' assets and, therefore, can divert these assets to further their own interests at the expense of the shareholders.¹¹ The normative implication of the Berle and Means critique of the modern corporation is that legal regulation is necessary to constrain the agency cost inherent in the "separation of ownership and control."¹²

The economic theory refuting Berle and Means shows that the parties to a corporation, as well as to other types of contracts, can choose among a wide variety of devices to minimize the organizational costs of doing business. Some of these devices rely on the operation of markets to reduce agency costs while others rely on judicial enforcement. If the parties are permitted to order their own affairs, optimal organizational forms will develop. In other words, as Professors Fama and Jensen have said, "[a]bsent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs."¹³

The parties can reduce agency costs resulting from the separation of ownership and control by monitoring managers, adjusting managers' incentives so that their interests are aligned with those of the shareholders, or by "bonding" managers to ensure that acts contrary to shareholder interests will be costly to the managers. But these activities can be costly. For example, close monitoring of managers can reduce their ability to exercise their expertise on behalf of the shareholders. Consistent with Fama and Jensen's general view of the corporate market, managers and shareholders will adopt monitoring, incentive and bonding devices up to the point where the marginal cost of such additional activities exceeds the marginal reduction in agency loss they cause.¹⁴

10. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1948).

11. *Id.* at 119-25.

12. *Id.* at 4.

13. Fama & Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 301 (1983) (emphasis added) [hereinafter Fama & Jensen, *Separation of Ownership*].

14. See Jensen & Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ANAL. 305 (1976). Jensen and Meckling define "agency cost" as comprising monitoring and bonding expenses and the agency loss remaining even after monitoring or bonding is in place. *Id.* at 309. For purposes of this article, "agency cost" is used in its more conventional meaning to refer only to residual agency loss.

Several examples demonstrate this general theory in operation. The corporate parties can reduce the agency cost inherent in the publicly held firm by the simple expedient of doing business in closely held firms where there is much less separation of ownership and control. But the parties would then forego the many benefits of the public, or "open" form of ownership, including diversification of risk, specialization of capital-raising and managerial functions, and development of an efficient market in the firm's shares.¹⁵ Thus, the very selection of the public form of ownership represents a trade-off of agency cost against the costs of closer monitoring in light of the circumstances of the particular business.

Within the publicly held firm, many devices exist for reducing agency costs. Perhaps most importantly, the shareholders have voting rights that can be aggregated by a bidder for control, who can reap gains in the value of their stock by improving management. This "market for corporate control," through the threat of displacing inept or disloyal managers, gives managers the incentive to maximize shareholders' returns.¹⁶ Also, the development of the board of directors as a long-range planning and policy group¹⁷ provides the corporation with an effective monitoring body.¹⁸ Effective monitoring can also be provided by large shareholders¹⁹ and outside auditors.²⁰ In addition, executive compensation can be structured to reduce conflicts between investors and managers and to signal that total agency costs are optimized.²¹ There also is a market for managerial services both within the firm and between firms whereby managers compete with one another for pay and promotions on the basis of their productivity.²² No one mix of governance mechanisms

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15. See Fama & Jensen, *Separation of Ownership*, *supra* note 13; Fama & Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101 (1985) [hereinafter Fama & Jensen, *Organizational Forms*].
 16. See Mann, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). For a recent review of the considerable evidence supporting the importance of the market for corporate control, see Jarrell, Brickley & Netter, *The Market for Corporate Control: The Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988).
 17. See A. CHANDLER, *STRATEGY AND STRUCTURE — CHAPTERS IN THE HISTORY OF INDUSTRIAL ENTERPRISE* (1962); O. WILLIAMSON, *MARKETS AND HIERARCHIES* (1975); Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537 (1981).
 18. See Fama & Jensen, *Separation of Ownership*, *supra* note 13, at 313-15.
 19. See Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985). For a study showing that corporations with different ownership structures tend to incorporate in different states on the basis of their differing needs for other monitoring devices, see Baysinger & Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J. L., ECON. & ORGAN. 101 (1985).
 20. See Watts & Zimmerman, *Agency Problems, Auditors, and the Theory of the Firm: Some Evidence*, 26 J. L. & ECON. (1983).
 21. See Diamond & Verrecchia, *Optimum Managerial Contracts and Equilibrium Security Prices*, 37 J. FIN. 275 (1982).
 22. See Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 660 (1980); Faith, Higgins & Tollison, *Managerial Rents and Outside Recruitment in the Coasian Firm*, 74 AM. ECON. REV. 660 (1984).

is universally optimal because corporations face different constraints such as capital requirements, product market competition and regulation.²³

The above discussion has emphasized non-judicial mechanisms for ensuring that managers act in the shareholders' interests. But there is also a place in economic theory and in the contractual view of the corporation for judicially enforced fiduciary duties. *Ex ante* constraints on fiduciary conduct often do not operate perfectly, so that *ex post* settling up through liability rules may sometimes be appropriate to fill gaps left by non-judicial mechanisms.²⁴ Among the most important reasons for the concept of fiduciary duties is that in long-term contracts it is costly to anticipate and draft for every contingency. This condition of "bounded rationality"²⁵ forces the parties to rely on alternatives such as standard form good faith or fiduciary duty terms provided by judicial decisions and statutory provisions.²⁶

Although fiduciary duties may sometimes be useful in filling gaps left by extra-judicial constraints on management misconduct, it is a serious mistake to assume that the parties to a corporate contract would view such duties as a panacea to be applied whenever gaps exist because the costs of judicially enforced fiduciary duties may far exceed the benefits in terms of constraining managerial conduct. First, fiduciary duties may result in imposing substantial costs on managers who, unlike the shareholders, are unable to reduce the risk by diversification and are therefore relatively inefficient risk-bearers.²⁷ As a result, liability may even exacerbate agency costs, as managers are induced to manage more conservatively than the shareholders would prefer. Second, derivative litigation imposes indirect costs, such as demands on managers' time and interference with valuable long-term relations between the managers and the corporation.²⁸ Finally, there are potentially significant error costs as courts substitute their judgments for those of the business experts on the board.²⁹

Even if judicially enforced liability is appropriate, the derivative suit

23. For a study linking these factors with variations in ownership structure, see Demsetz & Lehn, *supra* note 19.

24. See Davis, *Judicial Review of Fiduciary Decisionmaking — Some Theoretical Perspectives*, 80 NW. U.L. REV. 1 (1985).

25. The term originated in H. SIMON, *MODELS OF MAN* 198 (1957).

26. See Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 371 (1980); Davis, *supra* note 24; Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1092-93 (1981).

27. This point has been recognized even by anti-contractarians. See, e.g., Coffee, *supra* note 2, at 947.

28. See Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 72 CORNELL L. REV. 261, 268-70 (1986).

29. For a criticism of the application of judicial proceduralism to the managerial decisionmaking process, see Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984).

mechanism for fixing such liability is suspect. The derivative suit mechanism takes the discretion to decide what corporate litigation is appropriate out of the hands of corporate management and places it to some extent in the hands of a single shareholder or, more accurately, the plaintiff's counsel. As has often been noted by a leading anti-contractarian, the interests of plaintiff's counsel, like those of the managers, are imperfectly aligned with those of the shareholders.³⁰ The result of the derivative process can result in a case like *Polk v. Good*,³¹ a greenmail case that finally concluded with a settlement establishing noncontroversial voting procedures and providing for disclosure of plaintiffs' discovery material in exchange for \$700,000 in fees for plaintiff's attorney.³² It is not beyond the realm of probability that shareholders would want to limit such suits.

In light of the potential costs of fiduciary duties, the optimal contract in some situations may be a mix of fiduciary duties and extrajudicial enforcement devices. For example, review of transactions by outside directors may be a less costly method of reducing agency cost than imposing fiduciary duties on directors. It may be necessary to trade off the two approaches at the margin as stricter liability reduces outsiders' willingness to serve. Similarly, it may be efficient to substitute shareholder voting for director liability on economically significant transactions. This would free directors to exercise their judgment in recommending transactions without fear of liability, while screening potentially harmful transactions by shareholder voting. Again, at the margin, director liability is traded off for shareholder monitoring.

The anti-contractarians mistakenly assume that if some of a device is good for some companies, more is better for every company. Consequently, they argue that all companies should have independent boards³³ and the managers of all companies should be subjected to a federally mandated minimum standard of conduct.³⁴ Conversely, they argue that if an extrajudicial device does not achieve perfect results, fiduciary duties must be added to the mix even if the combined cost is not offset by the resulting reduction in agency loss.³⁵ These arguments, however, ignore

30. See Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (1985); Coffee, *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working*, 42 MD. L. REV. 215 (1983).

31. 507 A.2d 531 (Del. 1986).

32. *Id.* at 535.

33. See Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 404 (1975).

34. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

35. For an example of this type of analysis focusing on imperfections in incentive compensation of managers, see Coffee, *supra* note 2, at 943-45.

the need for trade-offs in structuring optimal corporate governance contracts.

The only way to identify the proper balance of corporate governance mechanisms for any particular corporation is through private ordering under truly enabling corporate statutes. First, the parties to the corporate contract, who bear all of the costs, have adequate incentives to fashion efficient rules. As Professor Coffee has said, "the case for private ordering is that the parties can recognize their own self-interest more quickly than the courts."³⁶ Moreover, legislative and judicial rules do not respond as well as private ordering to individual situations and changing conditions.³⁷ Finally, political agents, like corporate agents, are subject to private incentives that may cause them to act contrary to the interests of their constituents.³⁸

Ironically, the "crisis" which provoked the recent Maryland director and officer liability provisions probably resulted from application of the anti-contractualist view of corporate law. In *Smith v. Van Gorkum*,³⁹ the case that is widely credited with spawning the crisis in directors' liability insurance and statutory responses like that in Maryland,⁴⁰ the court held that both outside and inside directors had violated their duty of due care in recommending a merger. The defendants settled for \$23.5 million, only part of which was covered by insurance. The liability crisis that followed this decision was simply a statement by corporations that this liability was more costly than it was worth. In other words, corporations preferred to rely on monitoring by such governance mechanisms as outside directors or shareholder voting rather than pay the costs of director liability.⁴¹ The court's error would not have been so bad if corporations had been permitted to draft around this decision. But it took the current wave of statutory fixes to accomplish this seemingly innocuous result.

Economic theory thus provides credible support for the proposition that optimal corporate arrangements are far more likely to be achieved through private ordering than through mandatory legal rules. Nevertheless, anti-contractarians argue that mandatory legal rules are necessary

36. *Id.* at 931.

37. See Baysinger & Butler, *Revolution v. Evolution in Corporate Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557 (1984).

38. A recent illustration of this problem is state anti-takeover statutes. See Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Law*, 1988 WIS. L. REV. 365; Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

39. 488 A.2d 858 (Del. 1985).

40. See REPORT OF SUBCOMMITTEE ON DIRECTOR LIABILITY, MARYLAND STATE BAR ASSOCIATION, SECTION ON CORPORATION, BANKING AND BUSINESS LAW, COMMITTEE ON CORPORATE LAWS 5-7 (Nov. 16, 1987) [hereinafter *DIRECTOR LIABILITY REPORT*], reprinted in 18 U. BALT. L. REV. 254, 255-57 (1989) (Appendix).

41. See *supra* notes 16-22 and accompanying text.

because true private ordering is impossible, particularly in public corporations.

With a nod to Berle and Means,⁴² the anti-contractarians allege that arrangements within the public corporation are essentially adhesion contracts imposed by corporate managers on dispersed, ignorant shareholders.⁴³ But corporate contracts, even in the public corporation, are plainly not adhesion contracts. A public corporation competes for investment dollars with thousands of other corporations and thousands more of non-corporate investment vehicles, such as partnerships, franchise contracts and certificates of deposit. Even shareholders who are already in a corporation that proposes a revision of the contract can choose whether to vote for, vote against, abstain, sell their stock or mount a takeover bid or proxy contest. Nor is it significant that public corporation shareholders do not individually negotiate governance arrangements. The fact that most governance arrangements are set forth in non-negotiated standard forms is not a cause for concern, but rather increases efficiency by reducing transaction costs.

Even the lack of shareholder consent to individual terms presents no problem for the contract theory of the corporation.⁴⁴ The fact that a shareholder chooses to pay a certain price for a bundle of rights and obligations without incurring the substantial costs of understanding each term of the contract is no more troublesome than the fact that an automobile buyer pays several thousand dollars for an automobile without having the slightest idea how a carburetor works.

The relevant question is not whether the corporate contract is one of adhesion — plainly it is not — but whether markets adequately protect shareholders from entering into improvident contracts. The absence of individualized consent and negotiation are immaterial because public corporation shareholders are protected by the efficiency of the securities markets, a fact about which there now can be little doubt.⁴⁵ Because of the work of securities analysts and other information disseminators, all public information concerning a company, including the terms of contracts constraining managerial discretion, is efficiently reflected in securities prices. Thus, shareholders buying into a governance arrangement

42. See *supra* notes 10-12 and accompanying text.

43. See Brudney, *supra* note 2, at 1406; Sargent, *Two Cheers for the Maryland Director and Officer Liability Statute*, 18 U. BALT. L. REV. 278, 300-01 n. 99, (1989). Professor Sargent is able to dismiss the contract theory of the corporation on this ground in less than a paragraph.

44. For this reason, the extensive discussion of consent in Honabach, *Consent, Exit, and the Contract Model of the Corporation—A Commentary on Maryland's New Director and Officer Liability Limiting and Indemnification Legislation*, 18 U. BALT. L. REV. 310, 331-46 (1989), misses the mark.

45. Professor Michael Jensen, a leading efficient market theorist, has said that "there is no other proposition in economics which has more empirical evidence supporting it than the efficient markets hypothesis." Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 96 (1978).

get what they pay for even if they do not have any idea what they are getting.

Efficient pricing of contract terms protects shareholders and assures that resources will be allocated to efficient arrangements. It also gives managers incentives to develop more efficient arrangements or risk being ousted by someone who can reap a profit by buying control and improving the contract. Shareholders are similarly protected by efficient securities markets when they vote to approve changes in governance arrangements. Even if most shareholders do not know what they are voting on, an inefficient proposal provides an arbitrage opportunity for someone who can purchase voting shares and defeat the proposal.

The contract view of the corporation is not only supported by persuasive economic theory; it is also not refuted by the consent-based concerns of the anti-contractarians. In fact, so weak are the anti-contractarians' arguments that it is difficult to avoid the conclusion that they ultimately rest on history rather than on logic. The corporate form was born as a concession of state power rather than as the product of private contract.⁴⁶ Nearly a century of incorporation under primarily enabling, general incorporation laws apparently has not fully erased the marks of this ancestry from the modern corporation.

III. MARYLAND'S CHARTER OPTION PROVISION

Maryland has enacted two types of provisions intended to deal with the director liability "crisis." The first, discussed in this part, permits the shareholders to adopt a corporate charter provision expanding or limiting the damage liability of officers or directors except where they receive an "improper benefit or profit in money, property or services" or engage in "active and deliberate dishonesty" that is material to a judgment adverse to the director or officer.⁴⁷ The second provision, expanding directors' and officers' indemnification rights, is discussed in Part IV.

The Maryland charter option provision is based on a similar new provision in the Delaware code.⁴⁸ However, the Delaware provision applies only to directors and provides for broader limitations on the shareholders' opt-out power than the Maryland statute. In particular, shareholders under the Delaware statute may not eliminate director liability "[f]or any breach of the director's duty of loyalty to the corporation or its stockholders" or "[f]or acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."⁴⁹

Because the Maryland charter option provision permits the shareholders to decide to some extent the terms of the corporate contract, it is generally consistent with the contract theory of the corporation.⁵⁰ The

46. See *supra* notes 2-3 and accompanying text.

47. MD. CORPS. & ASS'NS CODE ANN. §§ 2-104(b)(8), 2-405.2 (Supp. 1988).

48. See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988).

49. *Id.* § 102(b)(7)(i),(ii).

50. There are two respects in which the charter option statute, by offering *too much*

provision is vastly superior in this respect to the bill originally proposed by the Subcommittee on Director Liability, which would have imposed a self-executing change in the liability standard on all Maryland corporations.⁵¹ The statute is also superior to the Delaware charter option provision because it permits the shareholders to limit the liability of both directors and officers,⁵² and to do so as to a broader range of conduct than is covered by the Delaware statute.⁵³

As discussed in Part II, under the contract theory of the corporation, the shareholders should be able to decide all of the terms of their contract.⁵⁴ Because management discretion can be constrained both by liability rules and by extrajudicial mechanisms, and because both approaches yield varying costs and benefits in different situations, optimal contracts can evolve only through private ordering. Thus, the shareholders could rationally decide that fiduciary duty liability in a particular setting would lead to sub-optimal decision-making by managers. The shareholders' choices are either bargained out directly, as in a close corporation, or constrained by the efficient securities markets.

Professor Sargent is, then, clearly incorrect when he criticizes the Maryland statute for ignoring the traditional distinction between the duty of care and the duty of loyalty.⁵⁵ To begin with, that distinction is subject to considerable dispute.⁵⁶ On one hand, under agency theory, all

shareholder choice, may be inconsistent with the contract theory of the corporation. First, if the shareholders can be said to have contracted for a limitation on the power of a majority of the shareholders to alter managerial liability, the charter option statute might constitute a retroactive alteration of that contract. See Butler & Ribstein, *The Contract Clause and the Corporation* (forthcoming BROOKLYN L. REV. (1989)). For a discussion of the retroactivity problem, see *infra* notes 72-73. The shareholders might want such a limitation to protect against opportunistic conduct by majority shareholders. However, it is questionable whether the statute can be read to provide for such a contract given the shareholders' broad amendment power, and the shareholders' power to reincorporate under statutes providing different contractual terms.

Second, the statute, by covering managers' liabilities to the "corporation," may unjustifiably permit the shareholders to control the terms of liabilities for the benefit of creditors as well as for excessive dividend distribution.

51. See DIRECTOR LIABILITY REPORT, *supra* note 40, at 1-3, 7-10, reprinted in 18 U. BALT. L. REV. at 254-55, 257-58 (discussing the proposed bill as well as the reasons for shifting to the charter option approach).
52. Compare DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988) with MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a) (Supp. 1988). It is not clear whether § 2-405.2 of the Corporations and Associations article of the Maryland Annotated Code, which permits "any provision expanding or limiting the liability of its *directors and officers*" permits the shareholders to limit the liability of *either* officers or directors but not both. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a) (Supp. 1988) (emphasis supplied).
53. Compare DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988) with MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a) (Supp. 1988).
54. See *supra* notes 13-45 and accompanying text.
55. See Sargent, *supra* note 43, at 300-01.
56. For a criticism of the care/loyalty distinction, see Fischel & Bradley, *supra* note 28, at 290-91. For commentary on the Fischel-Bradley position, see Scott, *The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel and Bradley*, 71

agency costs arise from divergence between the interests of the agent and the interests of the shareholders. Thus, even inattention to duty by the agent is a "disloyal" use of the agent's time to benefit himself rather than his principal. On the other hand, perhaps negligence is better monitored by extrajudicial monitoring devices like the market for control, while most breaches of the duty of loyalty are readily observable by courts.

In the final analysis, however, whether a distinction between the duty of care and the duty of loyalty is theoretically appropriate is completely irrelevant to whether the shareholders of a particular corporation should be compelled to include such a distinction in their contract. Even if it is accepted that the highly controversial conclusion that the distinction is workable and appropriate in many cases, this at most justifies making such a provision part of a statutory standard form that the shareholders can contract around. It does not justify limiting the shareholders' choice.

There is, in fact, good reason to believe that some shareholders would choose to opt out of liability for the duty of loyalty if given the opportunity. The problem is that while the care/loyalty distinction may be workable in many cases, it is hazy at the borders. For example, any takeover defense may involve a breach of the duty of loyalty if the managers are regarded as self-interestedly clinging to their jobs. Thus, liability for breach of the duty of loyalty may shift to the managers the cost of erroneous takeover defenses, making the managers less willing to engage in such defenses than the shareholders would prefer. The shareholders of a particular firm may therefore conclude that liability for breach of the duty of loyalty is excessively costly in this respect.⁵⁷ Of course, the shareholders of other firms may reach different conclusions. Because shareholder preference for takeover defense varies among firms, no single statutory approach is optimal for all firms.⁵⁸

A limitation on the shareholders' power to contract can be logically justified only by imperfections in the market's ability to constrain inefficient contract terms. The efficiency of the securities markets makes any such justification quite doubtful in this context.⁵⁹ But even if there were such a justification, there is no reason to believe that it would turn on the

CORNELL L. REV. 299 (1986); Goetz, *A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven*, 71 CORNELL L. REV. 344, 350-51 (1986); Demsetz, *A Commentary on Liability Rules and the Derivative Suit in Corporate Law*, 71 CORNELL L. REV. 352, 355-56; *Edited Transcript of Proceedings of the Business Roundtable/Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law and Economics*, 71 CORNELL L. REV. 357, 367-71 (1986).

57. Even if the shareholders carve out a liability exclusion for takeover defenses, a statutory restriction on loyalty-duty limitations creates uncertainty about the enforceability of such an exclusion, thereby making it impossible for the shareholders to eliminate the manager risk aversion problem.

58. See Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 837 (1988).

59. See *supra* notes 39-43 and accompanying text.

care/loyalty distinction. If markets adequately discipline contracts around the duty of care, there is absolutely no reason to suspect that they do not operate equally well regarding contracts around the duty of loyalty.

The Maryland statute therefore appropriately avoids the care/loyalty distinction. The principal issue regarding the charter option provision from the standpoint of the contract theory of the corporation is not whether the statute is too broad, but whether it inappropriately limits shareholder choice. The most important limitations are those prohibiting liability exclusion for "improper benefit" and "active and deliberate dishonesty," and the restriction of the scope of the statute to provisions relating to liability "for money damages."⁶⁰

The conduct exclusions do not present serious problems under the contract theory of the corporation because they arguably protect rather than limit shareholder choice. As to the "improper benefit" clause, it is significant that the shareholders can exclude liability for self-enriching conduct by managers if this conduct is not "improper." As long as the shareholders can define by contract what is "improper," this exclusion protects the shareholders from unconstrained *unilateral* abrogation of the contract by the managers. The only problem with this exclusion is that "improper" may have a broader meaning. The provision, therefore, should be redrafted to eliminate this ambiguity.

The exclusion for "active and deliberate dishonesty" also can be interpreted as preserving shareholder choice by ensuring that the shareholders are kept informed by their agents. Here too, the problem is ambiguity and potential overbreadth. The statute refers to managerial acts or omissions that are "*the result of* active and deliberate dishonesty." While this may refer only to corporate acts that are effectuated by means of misrepresentation or nondisclosure, as where a shareholder vote is procured by dishonesty, it may also refer more broadly to bad faith motivation of the agent. This broader reading comes dangerously close to preserving liability for breach of the duty of loyalty. Again, the statute should be clarified.

A more serious problem under the contract theory of the corporation is that the statute does not permit the shareholders to opt out of managerial duties liability, but rather only out of money damage liability for breach of these duties. Thus, the shareholders may not preclude suit for injunctive or prophylactic relief. Yet there are strong reasons why the shareholder would choose to opt out of these consequences as well. Suits for injunctive relief may cause considerable damage to the corpora-

60. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a) (Supp. 1988). Another limitation that bears examination from a contract perspective is that the statute applies only to liability by persons in their capacity as officers and directors. *See id.* § 2-405.2(c). The shareholders may have strong reasons for wanting to adjust the liability of employees and other corporate actors.

tion by delaying or preventing valuable transactions.⁶¹ Thus, the costs of this remedy may greatly outweigh the benefits in light of the availability of other monitoring devices.

The statute's limitations on shareholder choice are mitigated to some extent by the availability of the reincorporation option. To the extent that the parties to a corporate contract can avoid limitations on opting out by incorporating under another state's statute, there are no truly mandatory state provisions.⁶² This has given rise to a debate between contractarians and anti-contractarians as to whether the competition for corporate charters makes corporate law too permissive.⁶³

Largely ignored in the debate over the state competition for chartering business is whether the chartering market sufficiently overcomes limitations on shareholder choice in individual corporation statutes. In fact, reincorporation to escape mandatory rules is often a costly option. For example, it has been argued that Delaware is in a position to offer a uniquely stable corporation law because the state in effect bonds shareholders against opportunistic law changes through its dependence on corporation business.⁶⁴ Shareholders may have to trade off the costs of restrictions on contracting in Delaware for benefits of incorporating in Delaware. Also, as Professor Honabach points out, close corporations may be foreclosed from reincorporating by the costs of having to operate in their home state as a foreign corporation.⁶⁵ The latter problem is particularly serious because mandatory provisions make the least sense in close corporations, where direct bargaining among the parties is feasible.⁶⁶ For these reasons, mandatory provisions are inconsistent with the contract theory of the corporation despite the theoretical availability of the reincorporation option.

In conclusion, the Maryland charter option provision is consistent with the contract theory of the corporation except to the extent that the conduct limitations on opt-out may be interpreted as operating more broadly than merely protecting the shareholders' contract and the statute prohibits opt-out from non-monetary liability. Subject to these caveats,

61. See *Gimble v. Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974) (the court, recognizing this problem, imposed a \$25 million bond as a condition of enjoining the sale of a subsidiary).

62. See Honabach, *supra* note 42, at 336-37.

63. The leading works on each side of the debate are Cary, *supra* note 34 (lamenting Delaware's role in the so-called "race to the bottom" of corporate standards) and R. WINTER, *GOVERNMENT AND THE CORPORATION* (1978) (arguing that state competition for corporate charters operates for the benefit of shareholders because it is constrained by efficient capital markets).

64. See Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L., ECON., & ORGAN. 225 (1985).

65. See Honabach, *supra* note 44, at 344-45.

66. These costs of reincorporating permit the states to charge rents to corporations, part of which are appropriated by powerful interest groups within the state, particularly lawyers. See Macey & Miller, *Toward an Interest-Group Theory of Delaware Corporation Law*, 65 TEX. L. REV. 469 (1987).

the provision is clearly a commendable step toward complete recognition of private ordering in the corporation.

IV. THE INDEMNIFICATION PROVISION

As an additional reaction to the director liability crisis, the Maryland legislature amended the statutory provisions governing indemnification of officers and directors.⁶⁷ The most important changes permit the corporation⁶⁸ to enlarge the range of indemnifiable acts to include acts other than those proved to be in bad faith or the result of "active and deliberate dishonesty" or involving receipt of "improper personal benefit" or reasonable cause to believe that the act was unlawful; to permit indemnification of amounts paid in settlement of derivative suits; and to provide that the indemnification provided for in the statute is not exclusive of any other rights provided for by corporate act.⁶⁹

To the extent that the indemnification changes enlarge the shareholders' ability to opt out of liability, the changes are an appropriate step toward private ordering. But, unlike the charter option provision, the indemnification changes present serious problems under the contract theory of the corporation.

First, the statute seriously limits shareholder options by not permitting the shareholders to provide for more limited indemnification than what is specified in the statute. Although the statute arguably can be read as permissive rather than mandatory, the nonexclusivity subsection seems clearly to provide only for *expansion* of managers' rights of indemnification and not for limitation of those rights.⁷⁰

Second, and most importantly, the indemnification changes are thrust on the corporation without shareholder vote. Although the statute does not mandate indemnification in any particular case, it clearly permits the board to provide for indemnification that was not available before the changes.⁷¹ This state-decreed change⁷² in the corporate contract not only is inconsistent with the contractual theory of the corporation, but there is a strong argument that it violates the Contract Clause of the United States Constitution.⁷³

67. MD. CORPS. & ASS'NS CODE ANN. § 2-418 (1985 & Supp. 1988).

68. Note that unlike such statutes as § 145 of Title 8 of the Delaware Code Annotated, the Maryland statute does not specify how the corporate decision must be made. Compare DEL. CODE ANN. tit. 8, § 145 (1983 & Supp. 1988) with MD. CORPS. & ASS'NS CODE ANN. § 2-418 (1985 & Supp. 1988).

69. MD. CORPS. & ASS'NS CODE ANN. § 2-418 (1985 & Supp. 1988).

70. *Id.* § 2-418(g) (Supp. 1988).

71. See *supra* text accompanying note 69.

72. Professor Honabach suggests that changes decreed by the *shareholders* are also suspect. See Honabach, *supra* note 44, at 324. However, a shareholder amendment right is part of the contract.

73. U.S. CONST. art. I, § 10 ("No state shall . . . pass any . . . Law impairing the obligations of contracts. . ."). See Butler & Ribstein, *Anti-Takeover Statutes*, *supra* note 3.

The only possible justification for this impairment of the corporate contract is that it saves the shareholders the transaction cost of making a change in their contract that they would clearly favor.⁷⁴ This is a highly questionable argument. It is not clear that shareholders would generally prefer such a change. While, as discussed in Part III, the shareholders may have ample reason to want to limit managers' liability, they also may favor inclusion of liability rules in the mix of contractual mechanisms for reducing agency loss. Moreover, the shareholders' preference for liability rules will vary from firm to firm, so that there is little justification for an across-the-board change in all corporate contracts within the state. In any event, there is little reason to make a legislative "guess" that the shareholders would want the change where the transaction costs of private ordering are so low. A change in indemnification rights will undoubtedly be proposed by management because it is in their interests, and could be approved by the shareholders at little cost through a vote at an annual meeting.

The abrogation of the shareholders' contract is not "saved" by the fact that the shareholders can always avoid the change by reincorporating outside Maryland or by selling their shares.⁷⁵ The reincorporation option is costly, particularly since managers would oppose reincorporation to escape indemnification, so that the shareholders could reincorporate only by overcoming the free-rider problem that afflicts dispersed owners. Even if reincorporation is practicable, the shareholders' contract has been changed to the extent that avoidance of the indemnification provision has imposed the cost of reincorporation upon the shareholders. If the contract has been changed, it is no answer that the shareholders can escape the change by selling their shares. A change which negatively impacts the company will be reflected in the sale price of the shares.⁷⁶ Thus, sale only capitalizes, and does not permit escape

74. See Honabach, *supra* note 44, at 345. Even if this argument made sense under the contractual theory of the corporation, it is not clear it would pass constitutional muster as a "reasonable and necessary" impairment under the Contract Clause. See Butler & Ribstein, *Anti-Takeover Statutes*, *supra* note 3, at 635-42.

75. See Honabach, *supra* note 44.

76. It is no answer to this problem that the shareholders hold diversified portfolios. See Honabach, *supra* note 44, at 342. While diversification reduces the variance in expected returns of the shareholders' investments, it clearly does not prevent reductions in expected portfolio returns as a result of state changes in the corporate contract, any more than it completely shields shareholders from injury from managerial misconduct.

Professor Honabach would permit the state to make "routine," as distinguished from "fundamental," changes in the corporate contract, and would classify as routine any change the possibility of which was discounted in stock price. *Id.* at 340-41. However, because the future is never fully reflected in stock price, and because the whole purpose of changes in the corporation law is to adjust to new developments, it would be impossible to distinguish between these types of changes. Moreover, even if the distinction was possible as to one time period, it would be hopelessly complicated by the fact that different shareholders bought at different times.

from, the change in the contract.

It is curious that although the Maryland legislature refused to impose reductions in directors' liability on corporate contracts,⁷⁷ it was willing to impose changes in indemnification, which is itself a form of reduction in liability. Did the legislature simply fail to make the connection between the two types of provisions? It is worth noting that one difference between increasing indemnification and reducing liability is that attorneys' fees are generated only in the former case. This difference is consistent with the story that lawyers are the most important interest group in shaping corporate law.⁷⁸ Assuming this explanation is plausible, it points up the fact that even if private ordering sometimes leads to an imperfect result, the alternative — government regulation of the terms of corporate contracts — is not completely untainted.

V. CONCLUSION

The new Maryland provisions on manager liability present two completely different stories in terms of the contract theory of corporate law. The charter option provision is an important step toward a more complete recognition of private ordering in the corporation. The principal problem with this provision is simply that it does not go far enough. The legislature should complete the journey it started by clarifying and narrowing the exceptions to opting out of liability.

The changes to the indemnification statute are another story. Although these changes to some extent broaden the shareholders' options regarding indemnification, it is more important that at the same time they abrogate the shareholders' existing contracts by forcing more liberal indemnification on all Maryland corporations. This type of tampering with the corporate contract is unlikely to have the effect sought by the legislature of encouraging corporations to remain in Maryland. Instead, shareholders may well bid down the price of shares in Maryland corporations to reflect the risk of future tampering.

The contractual theory of the corporation is not only supported by economic theory, but itself provides a valuable tool for analyzing and evaluating corporate law. As state legislatures become more attuned to thinking of the corporation as a contract, corporate law inevitably will become more coherent. Moreover, as the law enhances private ordering, corporate contracts will become more efficient.

77. See *supra* notes 47-66.

78. See Macey and Miller, *supra* note 66, at 502-06.